Francois Groepe: Monetary policy and inclusive growth

Address by Mr Francois Groepe, Deputy Governor of the South African Reserve Bank, at the 3rd UBS Economics Conference, Cape Town, 12 October 2012.

*   *   *

Monetary policy and inclusive growth

I wish to thank UBS for inviting me to address you in my beautiful home town. The topic I have been asked to discuss today is monetary policy and inclusive growth. This topic is particularly relevant given South Africa's income inequality as reflected in the most recently estimated Gini-coefficient of 0,69. The top ten per cent of the population earn approximately 58 per cent of the income and the bottom 50 per cent less than eight per cent. We furthermore have had to contend with structural unemployment, which currently stands at 24,9 per cent.

I will now proceed with a brief overview of the concepts of inclusive growth and productive employment before discussing the South African Reserve Bank's (the Bank) mandate, the monetary policy framework and how the achievement of the Bank's mandate enables the most appropriate backdrop for inclusive economic growth.

Inclusive growth

Inclusive growth refers to long-term sustained economic growth that is broad-based across sectors and inclusive of a large part of a country's labour force, thereby reducing unemployment significantly. Policies that encourage inclusive growth tend to emphasize removing constraints to growth, creating opportunity, and creating a level playing field for investment. According to the World Bank's Commission on Growth and Development, a persistent, determined focus on inclusive long-term growth by governments is a key ingredient of all successful growth strategies.[1]

Long-term sustained high growth rates are further also dependent on productivity gains. Productivity gains lead to higher rates of growth that in turn result in rising demand for labour as the economy expands and incomes rise in a virtuous circle.

One well-known survey, by Lopez of the empirical literature on economic growth concludes that macroeconomic stability, low inflation rates, and appropriate education and infrastructure-related policies have positive effects on growth and reduce inequality.

More recent research initiatives have focused increasingly on constraints to future development and showed that a country's initial conditions have a critical impact on long-run growth. Initial conditions include levels of income and its distribution, the extent of poverty and many other factors including geography, governance and the set of existing macroeconomic policies. World Bank research in 2005 highlighted the extent to which institutional structures, policies, and resource endowments interact in unique ways to support necessary policies such as a stable macroeconomic environment, the enforcement of property rights, openness to trade and effective government in achieving higher growth rates.[2] The line of enquiry further suggested that local peculiarities would tend to result in unique sets of distortions that impede growth. In South Africa this would include inadequate infrastructure, skills shortages and inefficient administration at the local authority level. Efforts

---

1 Commission on Growth and Development Growth Report: *Strategies for Sustained Growth and Inclusive Development*, World Bank, (2008).

2 World Bank. *Economic Growth in the 1990s: Learning from a Decade of Reform*. Washington DC: World Bank (2005).

to address the distortions and constraints could in practice result in short-term costs, in particular if local circumstances are not well understood. If however approached judiciously, it should yield positive results over the medium to longer term.

It was against this background that Hausmann, Rodrik and Velasco developed their approach to identifying binding constraints to growth. Important lessons from this and other research were that development policy is country specific rather than being one-size-fits-all and that sometimes large positive welfare impacts could be achieved by optimally sequencing just a few reforms to relax binding constraints. Empirical evidence also showed that in every country structural transformation and economic diversification are required to achieve significant income growth and poverty reduction. For countries with relatively small domestic markets like South Africa this implies export diversification in order to access foreign markets and achieve economies of scale.

Productive employment

Productive employment is the main instrument for achieving sustainable and inclusive growth. Employment growth generates new jobs while productivity growth lifts the wages of the employed and the returns to the self-employed.

The key objective with any growth strategy is to strengthen the productive resources and capacity of individuals on the labour supply side and to open up new opportunities for productive employment on the labour demand side.

An inclusive growth strategy should also recognize the time lag between reforms and outcomes as in the case of investments in education and the time elapsed before improved labour skills become available. Efforts to narrow the knowledge gap with the goal of developing creative and competitive human resources are an important prerequisite for higher productivity. South Africa should aim to not merely catch up in this regard. We need to pre-empt the type of skills and knowledge that will be required over the next say two decades and ensure that our education and training strategies are adequately aligned so as to ensure that we have a work force with the appropriate skills. It is, therefore imperative that our human capital development strategy is forward-looking and proactive.

This necessitates us to take a hard look at our education system, as a recent assessment of the quality of state education amongst 142 countries, ranked South Africa at 133rd, despite the high levels of investment in education which now stands at R207bn per annum.

Planning must therefore focus sharply on upgrading the quality and relevance of training while enhancing the skills of the labour force. In order to upgrade human resource skills to meet the need of an increasingly sophisticated economy, training at every level must be strengthened to generate well-trained labour to meet industry demand both now and in the future. An inclusive growth strategy looks for ways to raise the pace of growth by utilizing the labour force to the fullest possible extent.

High unemployment is the result of chronic skill and geographical mismatches and of policies, product market structure, and labour market arrangements that often protect insiders at the expense of the unemployed. High margins in product markets and upward wage pressure in labour markets have resulted in uncompetitive domestic costs of production in a number of sectors. This erodes external competitiveness and as a consequence excludes part of the population from formal economic activity. It also ends up constraining a country's ability to diversify exports. Entry-level wages are also sometimes above the productivity levels of less experienced workers and new entrants to the labour market. This discourages labour demand.

Sustainable job creation that significantly reduces unemployment can be achieved with labour and product market reforms that specifically target labour intensive production processes. A more flexible wage setting mechanism that better aligns wages with productivity levels at the firm level will improve the business environment and our competitiveness and should significantly contribute towards increasing employment opportunities.

Important factors that serve to improve individual and enterprise or micro productivity include improved management skills, updated technology and better capital equipment. Collective factors at the enterprise level that have a decisive influence on productivity outcomes include the adoption of the continuous-improvement-type work ethic and overall quality consciousness that is so prevalent in Developing Asia. In many countries, active labour market policies also serve to raise the rate of employment creation. This includes, transport subsidies for job seekers, on-the-job training and in some instances, temporary youth wage subsidies.

Infrastructure as a key jobs driver

Emerging-market and developing country growth is on average higher than that of South Africa and is indicative of country specific structural constraints. A sustained increase in the potential output of the economy requires not only a concerted and coordinated effort from government, but also the support and buy-in of the private sector and labour if we were to succeed in improving the growth performance. It may even require a new social compact.

In the past, infrastructure development in particular has been held back largely due to limited implementation capacity. This has resulted in bottlenecks in electricity generation, transport, and port infrastructure and South Africa has therefore not benefited as much as other resource intensive emerging market economies from large terms of trade gains in recent years. This also discouraged investment in South Africa's natural resource industry, and has made it difficult in some instances to maintain export volume growth. Policy certainty and investor confidence have proven to be essential prerequisites for the capital formation South Africa requires for substantive export led growth.

The New Growth Path sets the goal of creating 5 million new jobs by 2020 and to this end identifies the structural problems in the economy that need to be overcome as well as the key opportunities or job drivers in specific sectors and markets. One of the key jobs drivers is infrastructure development which provides the basis for higher growth, inclusivity and job creation. Government has also established the Presidential Infrastructure Coordinating Commission (PICC) to address the challenges of delivery through coordination, integration and accelerated implementation. A single common Infrastructure Plan will in future be centrally driven and monitored. The objective is also to develop a twenty-year planning framework beyond one administration to avoid the typical stop-start pattern of the past. The PICC's mandate is to ensure systematic selection, planning and monitoring of large projects.

An infrastructure book that contains more than 645 infrastructure projects across the country has now been compiled by the PICC. An Infrastructure Plan with identified Strategic Integrated Projects has also been developed by the PICC and adopted by Cabinet and although this in itself will not address all the challenges, it forms an important part of the National Development Plan's (NDP) proposals to increase employment and growth Other key proposals of the NDP include improving the functioning of the labour market, supporting small business through better coordination of activities and improving the capacity of the state to effectively implement economic policy.

Although South Africa has at times over the past 18 years, achieved significantly improved real economic growth outcomes, built democratic institutions, transformed the public service, extended basic services and stabilised the economy, too many people are still trapped in poverty and too few South Africans have obtained employment over this period as growth has not been sufficiently inclusive. The quality of education for the majority has remained poor and government has continued to experience insufficient capacity in critical areas. Some years were characterised by jobless capital intensive growth while the large employment losses that this country suffered during the recession have still not been recovered fully. The NDP aims to eliminate poverty and reduce inequality significantly by 2030 by growing an inclusive economy and creating 11 million jobs by 2030.

Recent developments in the labour market

Although employment levels have increased at a slower pace this year compared to 2011, the rate of job creation has been sufficient to decrease marginally the unemployment rate in the second quarter of 2012. Employment creation has nevertheless remained hesitant, consistent with the moderate pace of recovery in real economic activity in South Africa and against the backdrop of the challenging global economic developments.

The moderation in average wage settlement rates in 2011 levelled off in 2012. In the second quarter of 2012, both the rate of increase in remuneration per worker and productivity increased somewhat resulting in the growth in nominal unit labour cost remaining the same. These developments mitigated inflationary pressures, but the outlook for wage growth has become uncertain.

Recent industrial action has spilled over from mining to the manufacturing, transport and agricultural sectors and has raised investors' concerns. Moody's Investors Service also mentioned spreading labour turmoil as an important factor in its decision to cut South Africa's debt rating to Baa1 from A3. Widespread labour unrest has already shut down large parts of the mining industry and given that we are the world's top platinum producer and a major supplier of gold, prices of precious metals have risen. The rand's exchange value has reflected investor concerns in recent weeks, and although the negative consequences of the unrest cannot be underestimated, I am confident the currency will return to more appropriate levels.

The rand will remain vulnerable to any signs of intensifying labour turmoil, but government has taken steps to address the labour unrest as a speedy resolution is crucial to restoring broader investor confidence and medium-term growth prospects. The government has also given the assurance that it is putting immense efforts into bringing together the employer community, trade union movement and the government itself in order to stabilise the situation as rapidly as possible. The longer strikes continue, the greater the implications will be for economic growth, employment creation and fiscal outcomes in the long run.

The role of monetary policy

I have earlier made reference to the Lopez survey that concluded that macroeconomic stability and low inflation rates inter alia have positive effects on growth and reduce inequality. It is my contention that transparent, well-understood monetary policy is critical to achieving stable macroeconomic outcomes. The mandate of the South African Reserve Bank is to achieve and maintain price stability in the interest of balanced and sustainable economic growth. The Bank also plays a central role in overseeing and maintaining financial stability.

Price stability reduces uncertainty in the economy and provides a favourable environment for growth and cumulative employment creation over the longer term. Low inflation helps to protect the purchasing power and living standards of all South Africans. Although low inflation may not necessarily in itself reduce income inequality, it does ensure the protection of income which is particularly important for poorer South Africans who generally do not have the means to adjust their nominal incomes to take account of rapid price increases.

An inflation target range is set by government after consultation with the Bank. The commitment is to pursue a continuous target of 3 to 6 per cent for headline CPI inflation. The Bank conducts monetary policy within a flexible inflation-targeting framework that allows for inflation to be temporarily outside the target range as a result of mainly supply shocks. The Monetary Policy Committee (MPC) takes into account the appropriate medium-term time horizon for inflation to return to within the target range, considering the lags between policy adjustments and economic effects. This provides for interest rate smoothing over the cycle and makes growth more sustained and consistent.

Since the implementation of inflation targeting, the instances when inflation outcomes exceeded the target could be attributed to external shocks which exacerbated domestic inflationary pressures. These shocks, amongst others, included depreciation of and volatility in the exchange rate of the rand and sharp increases in international oil, commodity, and food prices. Structural features of the South African economy such as backward looking wage settlements, uncompetitive product markets, rapidly rising administered prices and low productivity have also been important sources of inflationary pressures.

It is very difficult to distinguish comprehensively between the specific impact of inflation targeting and the general impact of other concurrent economic reforms or global developments. However, empirical evidence shows that gains in inflation performance in inflation targeting countries were achieved with no adverse effects on output and interest volatility. The inflation targeting framework has also served South Africa well and the most important outcomes it has contributed towards can be summarised as follows:

- The nominal policy interest rate has declined. This has lowered the interest rate structure at the short end of the maturity spectrum.
- The real policy interest rate has declined and has become less volatile. This has reduced the inflation risk premium embedded in interest rates as inflation expectations became better anchored.
- Nominal bond yields have declined. This has lowered the cost of borrowing of government and the cost of funding of the private sector to the benefit of real economic activity.
- Growth in real gross domestic product and real gross fixed capital formation has increased and become less volatile. This has encouraged employment creation, particularly in the pre-crisis years.

The extent of the gains derived in part from inflation targeting largely depends on the Bank's ability to anchor inflation expectations within the inflation target range. Anchored inflation expectations reduce the effect of external shocks and require less policy intervention.

The inflation targeting framework has been important in providing greater resilience to the large shocks coming from the global external environment. As the nominal exchange rate of the rand is determined by supply and demand conditions, exchange rate flexibility serves as an important transmission mechanism and shock absorber of external shocks. This approach allows output growth and interest rates to be less volatile and delivers the best outcomes in terms of price stability and lower exchange rate volatility subject to the risk of over- or undervaluation in response to external shocks.

Inflation targeting has also been successfully practiced in a growing number of countries over the past 20 years, and many more countries are moving toward this framework. Empirical evidence on the performance of inflation targeting is supportive of the effectiveness of the framework in delivering low inflation. The monetary policy framework has allowed the Bank to provide stimulus when required while keeping inflation expectations well anchored. Since its introduction in 2000, inflation targeting in South Africa has been applied as a flexible framework that has been resilient to changing circumstances, including the recent global financial crisis. The inflation targeting framework has thus far enabled the Bank and most of the other inflation targeting countries to steer clear of unconventional measures in achieving their key monetary policy objective. The Bank's inflation forecast shows inflation remaining within the inflation target range over the forecast horizon to 2014.

Conclusion

Although there is a short-run trade-off between economic activity and monetary policy, it is generally accepted that low and stable inflation produces an environment in which overall economic performance and inclusive growth can flourish. The Bank's flexible approach to inflation targeting, I believe positions South Africa to best deal with external shocks and minimise their disruptive impact on the domestic economy. Growth, employment and income levels have been more stable and consistent since 2000 and the introduction of the current inflation targeting framework.

Achieving greater economic inclusion is a critical need for the country. Monetary policy should be complemented by growth-oriented and job-creating fiscal, industrial and labour policies. Emerging market and developing economies are now more resilient than in previous decades but structural issues still need to be addressed. Weaknesses in any subsector or in regulation or corporate governance will limit monetary policy efficacy and lead to weak growth, which in turn is a drag on fiscal consolidation. Policies in general must therefore emphasise the resolution of underlying structural problems within the economy, and monetary policy must be as supportive as possible, with due regard to ensuring price stability. Although monetary policy can therefore contribute to inclusive and sustainable growth (and you will probably agree that the SARB has indeed adopted policies that are supportive in this regard), one needs to recognise the limitations of monetary policy and hence acknowledge that other policymakers and stakeholders also have an important and significant role to play in achieving both inclusive and sustainable growth over the longer term.

Thank you.

References:

Aron J. and Muellbuaer, J., "Transparency, credibility and predictability of monetary policy under inflation targeting in South Africa", Department of Economic, Oxford and Nuffield College, Oxford, 31 March 2007.

Ianchovichina, E and Lundstrom, S. What is Inclusive Growth?, Policy Research Working Paper No. 4851, The World Bank. 2009

Hausmann, R., Rodrik D., and A. Velasco. Growth Diagnostics. Mimeo, Harvard Kennedy School. Cambridge. 2005.

Lopez, H. "Pro-Poor Growth: A Review of What We Know (and of What We Don't)" Mimeo. World Bank. 2004

The Infrastructure Plan, Presidential Infrastructure Coordinating Commission (PICC), April, 2012.